Office of Chief Counsel
Internal Revenue Service

memorandum

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BJLaterman

date: JUN 15 2001

to: Kevin Benner, Team Manager
Attn: Manuel Melo, International Examiner

from: Associate Area Counsel, LMSB, Boston

subject: **I.R.C. § 863(b) Foreign Source Income**
[redacted] - Maquiladora

This memorandum responds to your on going request that we give advice regarding when a taxpayer may source income arising from production (of inventory property) in a Mexican Maquiladora subsidiary by reference to I.R.C. § 863(b). This memorandum should not be cited as precedent.

The taxpayer is a U.S. corporation which has U.S. subsidiaries. Some of the U.S. subsidiaries have Mexican subsidiaries (i.e., the Maquiladora subsidiaries) which produce goods in Mexico for resale in the U.S. market. The Maquiladora subsidiaries perform packaging, assembly and other manufacturing operations under the supervision of employees of the U.S. subsidiaries, using machinery and equipment and materials and supplies, all of which are owned by the U.S. subsidiaries.

The results of the operations of the U.S. subsidiaries are included in the taxpayer's consolidated return. The taxpayer has argued that it may source the income arising from the production in the Maquiladora subsidiaries by reference to I.R.C. § 863(b).

A taxpayer which sells purchased inventory within the U.S. will have 100% of the income generated from such sales sourced within the U.S. pursuant to I.R.C. § 861(a)(6). However, if the taxpayer is producing such inventory (in whole or in part) outside the U.S., I.R.C. § 863(b)(2) may source a portion of the income outside the U.S. The effect of such sourcing may be to increase the foreign tax credit limitation under I.R.C. § 904. The instant taxpayer, whose U.S. subsidiaries sell inventory produced by their foreign (Maquiladora) subsidiaries, is asserting that I.R.C. § 863(b)(2) applies to the income generated from the U.S. sales.

I.R.C. § 863(b)(2) provides that gain, profits and income from the sale of inventory property [within the meaning of I.R.C. § 865(i)(1)] produced (in whole or in part) by the taxpayer within and sold or exchanged without the U.S., or produced (in whole or in part) by the taxpayer without and sold or exchanged within the U.S., shall be treated as derived partly from sources within and partly from sources without the U.S. While I.R.C. § 863(b)(2) sources income when a taxpayer produces inventory (in whole or in part) without the U.S. and sells within the U.S., it must be the taxpayer who is producing the inventory. Furthermore, I.R.C. § 864(a) provides "for purposes of this part, the term produced includes created, fabricated, manufactured, extracted, processed, cured, or aged." See also, Treas. Reg. § 1.863-3A (a)(2).

Taxpayers who sell products produced by a foreign subsidiary have argued that: (1) since the subsidiary is performing under the direction of the U.S. taxpayer, the production activities of the subsidiary can be attributed to the U.S. taxpayer; and (2) since the taxpayer has some of its employees or management working at the subsidiary's manufacturing plant, the taxpayer is producing. With regard to the attribution argument, pursuant to I.R.C. § 863(b)(2), the taxpayer must produce the inventory and attribution of production activity from a controlled foreign corporation does not satisfy the requirement. The National Office's longstanding position is that attribution does not apply. As to the second argument, there is no legal authority or guidance defining the scope of produce for purposes of I.R.C. § 863(b)(2). Therefore, the specific facts and circumstances of each case need to be examined; i.e., the job duties of the taxpayer's employees and management at the subsidiary's manufacturing plant must be determined.

If it is determined that I.R.C. § 863(b)(2) applies to the gross income derived from the sale of inventory (because it is determined that the taxpayer itself produces the inventory), the regulations are applied to source the income. Treas. Reg. § 1.863-3A applies to taxable years beginning before December 30, 1996. Treas. Reg. § 1.863-3 applies to taxable years beginning after December 30, 1996. A taxpayer, however, may apply the current regulations to tax years beginning after July 11, 1995 and before December, 30, 1996. The prior and current regulations differ in regard to the allocation of the income. However, the definition of "produce" has not changed except to the extent that the current regulations explicitly require a taxpayer must directly own and directly use the assets which are used to produce the inventory prior to the assets being included in the allocation fraction. <u>See</u> Treas. Reg. § 1.863-3 (c)(1)(i).

International Examiner Manuel Melo has informed our office that the taxpayer's main argument is that the presence of U.S. subsidiaries' personnel at the Maquiladora subsidiaries manufacturing facilities results in compliance with the requirements of both the prior and current regulations. This memorandum has previously indicated that evaluation of the merits of the taxpayer's argument turns on examination of the specific facts and circumstances of each case. Without such an evaluation it is difficult to determine the strength of the government's case. (b)(7)a [redacted], we will support a disallowance in the event that your analysis of the employees' job duties establishes that these activities do not constitute production on the part of the taxpayer.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Our office has coordinated this analysis with Juan A. Alvardo, Maquiladora TA and Attorney Anthony Ammirato, Attorney of the Maquiladora Technical Advisor Team. If we can be of any further assistance, the undersigned can be reached at 617-565-7855.

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